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## How monetary policy affects inflation

Monetary policy mainly affects inflation by the Riksbank raising or cutting the policy rate. The level of inflation is largely determined by changes in economic activity and developments in the exchange rate when the Riksbank adjusts the policy rate. If inflation is lower than the target of 2 per cent, the Riksbank can help boost inflation by cutting the policy rate, which increases economic activity and contributes to a weaker exchange rate. In the same way, the Riksbank can raise the policy rate if inflation needs to be subdued.

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## Short video about how the policy rate influence the economy and the level of inflation

### The monetary policy transmission mechanism

The way in which monetary policy affects inflation and the real economy – output and employment, for example – is referred to as the monetary policy transmission mechanism. The transmission mechanism is actually not one but several different mechanisms that act in parallel, through different channels. Some of these mechanisms affect inflation rather directly, while others take longer to have an effect.

One common way of describing the monetary policy transmission mechanism is that it operates through the following channels:

- the interest rate channel,
- the exchange rate channel,
- the asset price channel, and
- the expectations channel.

You can read more about these channels by clicking on the headings below. It is important to remember that the division into different channels is an attempt to describe a complex process in which different mechanisms engage and interact. To simplify, the channels are described in a way that allows them to be perceived as separate. But in practice there are strong links between the channels and it is therefore not clear how to draw the boundaries between them.

Let us take as an example below that inflation is too high and that the Riksbank therefore raises the policy rate. How does monetary policy affect inflation via the four channels of the monetary policy transmission mechanism?

#### Interest rate channel

The interest rate channel describes how the Riksbank can influence interest rates and thus the level of activity in the economy, which in turn affects inflation.

One aspect that is important to bear in mind when discussing the level of the policy rate is that its normal level is affected by the general level of interest rates. A rate lower than normal stimulates demand and inflation, while a higher rate has the opposite effect. Interest rates in Sweden are governed by the general level of global interest rates, which has been falling for a few decades. This is not because the central banks have pursued an increasingly expansionary policy, but because global savings have been high. When the supply of savings is high in relation to the demand for savings, that is, money used for investment, interest rates, including the central bank policy rate, fall. The normal level of the policy rate is therefore lower today than it was 20 or so years ago. A policy rate level that had an expansionary effect on the economy at that time, may therefore have a tightening effect today.

How does a change in the policy rate affect inflation? Let us take as an example below that inflation is too high and that the Riksbank therefore raises the policy rate. This at first affects the short-term interest rate that the central bank is trying to control. In the Riksbank's case, this is the overnight rate, which is the interest rate paid by banks when they borrow from each other from one day to the next. Market rates with longer maturities are affected by expectations of what short interest rates will be going forward. This means that an increase in the overnight rate spreads and pushes up other interest rates in the economy, such as the banks' and mortgage institutions' interest rates.

For households, saving becomes more attractive when interest rates are higher. In addition, households need to use a larger proportion of their income for interest payments on loans. Both of these factors contribute to the consumption of fewer goods and services by households. For companies, higher interest rates mean that it becomes more expensive to finance investments and they therefore invest less in machinery and property. When households reduce their consumption and companies their investment, this causes inflation to fall.

### Exchange rate channel

A change in the policy rate also affects the exchange rate. When Swedish interest rates rise in relation to interest rates abroad, foreign agents become more interested in investing in Sweden as it gives higher returns than investments in other currencies. This leads to an increase in demand for the krona (SEK). When demand for the krona increases, its price rises, just as the price of any product does when demand for it increases. As the exchange rate in relation to other currencies represents the price of SEK, the krona exchange rate strengthens, i.e. we have to pay less SEK for a dollar or euro, for example. This makes Swedish goods more expensive for households and companies abroad, which means that demand for Swedish products declines. The result is a reduction in Swedish exports to other countries. This leads to lower activity in the Swedish economy and puts downward pressure on inflation. At the same time, the prices of imported goods become cheaper in SEK, which also contributes to lower inflation.

### Asset price channel

The level of interest rates also affects the prices of various assets. When interest rates are higher, it becomes more profitable to save in a normal bank account and the prices of assets, such as shares and housing, may decline. This also contributes to lower consumption, as it makes households that own such assets less willing to spend money. Banks, which use the assets as collateral, may also be less willing to lend to households and companies.

Even here, it is important to bear in mind that not all movements in interest rates are due to the Riksbank changing the policy rate, i.e. its monetary policy. Changes in the general level of interest rates, and thus in the normal level of the policy rate also play a part in the development of asset prices. The fact that the general level of interest rates has fallen in a longer perspective is therefore probably an important explanation for the fact that housing prices are higher today than they were a couple of decades ago.

### Expectations channel

Higher interest rates thus dampen demand in the economy. Since households' and companies' consumption and investment today are influenced by what they think about the future development of the economy, demand can also be dampened if they expect higher interest rates going forward. The fact that the central bank raises the policy rate and also communicates about the level of the policy rate in the future, for example when the Riksbank adjusts its forecast for the policy rate upwards, can therefore have a dampening effect on the economy via expectations.

The inflation expectations of households and companies are important for the development of inflation. For example, if they expect inflation to remain high, they will adjust their price-setting and wage-setting decisions accordingly. This, in turn, fuels price increases and wage growth, leading households and companies to continue to expect high inflation, and so on. This was what happened during the 1970s and 1980s.

If they instead expect inflation to be 2 per cent, they will again adjust their price- and wage-setting decisions accordingly. This also makes it easier for the Riksbank to maintain the target. Part of the expectations channel is therefore a question of conducting a monetary policy that anchors inflation expectations in the economy at 2 per cent.

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